Statement

of

Timothy J. McCormally

Executive Director
Tax Executives Institute

on behalf of

Tax Executives Institute, Inc.

on

Managing Change: Investment in People Resources

before the

IRS Oversight Board

January 26, 2004

Good afternoon. I am Timothy McCormally, Executive Director of Tax Executives Institute, the preeminent association of business tax professionals. I am accompanied by the Institute's General Counsel and Director of Tax Affairs, Fred Murray. The Institute is pleased to participate in today's hearing of the IRS Oversight Board.

Background

Tax Executives Institute was established in 1944 to serve the professional needs of in-house tax practitioners. Today, the Institute has 53 chapters in the United States, Canada, and Europe. Our 5,400 members are accountants, attorneys, and other business professionals who work for 2,800 of the leading companies in North America and Europe; they are responsible for conducting the tax affairs of their companies and ensuring their compliance with the tax laws. Hence, TEI represents the business community as a whole, and our members deal with the tax code in all its complexity, as well as with the Internal Revenue Service, on almost a daily basis. TEI is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike.

The companies that employ TEI's members have almost without exception been assigned to the IRS's Large and Mid-Size Business (LMSB) Division. The largest 1,600 taxpayers within LMSB are subject to ongoing audits as part of the Coordinated Industry Cases (CIC) program. The Institute's testimony is largely based upon our experience with this segment of IRS operations. TEI has long supported adequate funding for the IRS, particularly in respect of training. We are pleased to offer our views on the investment in human resources within LMSB and, more generally, on the overall direction of the IRS.

Increased Demand, Decreased Resources

Effective management of human resources is not a new challenge, but it is one that is garnering more attention and importance as the government's workforce ages. The Office of Management and Budget recently announced that all federal agencies will be required to include in their fiscal year 2005 budgets and annual performance plans specific activities relating to training, development, and staffing to ensure leadership continuity. The Office of Personnel Management has also established a goal to ensure continuity of leadership and knowledge through succession planning and professional development programs in 25 percent of federal agencies by July 2004.

The IRS Oversight Board's 2003 report to Congress also focused on personnel issues. The Board observed an increased demand for IRS services and a decreased level of resources. Specifically, the Board documented a 16-percent increase in the IRS's workload between 1992 and 2002 and, during the same period, a 16-percent *decrease* in the number of full time equivalent employees (from 115,205 to 96,714). The Board explained that the result of these trends is a huge gap between what taxpayers need and what the IRS can deliver to them. Closing the gap is one of the IRS's greatest challenges, the Board concluded.[1]

Nor is the United States alone in its need for a stable public workforce. For example, last October the General Accounting Office reported that in Canada approximately 80 percent of the

---

1 *See IRS Oversight Board Annual Report* at pages i-ii (April 2003).

public service executives and executive feeder groups will be eligible to retire by the end of the decade.[2]

In an exit interview last year, former LMSB Commissioner Larry Langdon reported that during his five years at the IRS the LMSB workforce declined by 600 employees. Forty percent of LMSB's revenue agents will be eligible to retire in FY2006, and that number will rise to more than fifty percent in FY2008. Among the division's managers, approximately forty percent are currently eligible to retire.

These statistics underscore what may be the greatest challenge for the IRS over the next five years — its personnel. LMSB is responsible for ensuring compliance by approximately 180,000 entities each of whom has more than $10 million in assets. These taxpayers are the largest enterprises, and correspondingly have the most complex issues and the most complex organizational structures. They themselves employ qualified tax attorneys and accountants and, in return, they require experienced, well-trained agents to understand the complexities and to audit those returns. The success of the agency — and the LMSB Division in particular — depends on an effective, efficient, well-trained, and motivated staff.

Recruitment Drives

The LMSB Division has taken important steps to address the problem. For the first time last year, LMSB held two recruitment drives for mid-career personnel. For example, of the 200 new revenue agents hired last fall, approximately two-thirds were mid-career employees hired at the GS-13 level. These new employees generally had a minimum of five years' corporate tax experience and either were a CPA or held a masters degree in taxation. (Several were members of TEI.) The division will continue hiring mid-level employees in the same ratio this spring, assuming funding is provided in the FY2004 budget, though candor requires an acknowledgment that, as the economy improves, attracting high-quality candidates at existing pay levels may become more difficult.

TEI supports LMSB's efforts to hire experienced personnel by circulating job announcements among our membership and encouraging members to apply for the positions. Previously, LMSB has hired agents from within the IRS, primarily using personnel from the Small Business/Self-Employed Division as its feeder organization. Seeking qualified individuals from outside sources not only

---

[2] *See* General Accounting Office, *Human Capital: Insights for U.S. Agencies from Other Countries' Succession Planning and Management Initiatives* (GAO-03-914) (October 1, 2003).

provides LMSB with agents who can contribute immediately to the Division's important work, but also mitigates the ripple effect of its hiring practices within other divisions of the IRS.

Critical Pay

Another hiring practice that has proven successful within LMSB is the use of critical pay for senior executive positions. This mechanism has permitted LMSB to hire highly experienced tax professionals at the most senior levels of the division. In our view, this experiment has proven successful and should be continued.

Funding

The recruitment and retention of qualified personnel depends in large measure on the IRS's securing sufficient funds to do its job. The lack of predictable funding can have unintended effects on IRS programs. A key feature of the IRS reorganization was to move from a "back-loaded" (post-filing) to a "front-loaded" (pre-filing) system and thereby remove the "archeological dig" aspect of examinations. Some recent announcements, however, *may be counterproductive to this goal* — and may result from efforts to manage resources in the short term. For example, the Office of Chief Counsel recently announced a "no-ruling" policy for section 355 distributions of stock and securities. While the stated purpose of the change (to permit Counsel personnel to focus on matters of broader applicability) is laudable, the policy may well have the perverse effect of making the resolution of issues more difficult by moving resources from the front end — *i.e.*, before the stock or security is distributed and the return is filed — to the back end — *i.e.*, when the return is finally audited (which could be several years later and, consequently, could pose fact-finding or other challenges). Thus, the ruling policy might hinder, rather than help, the IRS's long-term goal to become more current in its audit cycles.

Specialists

One area where LMSB should consider additional training is in respect of its specialists. Although a recent informal survey of TEI members suggests that LMSB's currency efforts are beginning to speed up audits, our members report that the effective integration of specialists into the audit process remains a challenge. Additional training in areas such as accounting principles, the latest technology, and business practices is also needed.

Summary

If the IRS is to respond to taxpayer needs and administer the tax code in a fair and efficient manner, the agency must have the resources necessary to fulfill its mission, including funds to attract, train, and retain top-notch tax professionals. And the funding must be used for staffing, instead of being diverted (as has occurred frequently in the past) to unfunded mandates. TEI has consistently supported adequate funding for the IRS, subject of course to oversight by this Board, the Treasury, and Congress. We know the Board shares our concern and urge you to continue to press for adequate funding of the IRS, particularly in the areas of employment and training.

Tools for Enforcement

As the Oversight Board has rightly observed, the IRS must work harder and smarter. LMSB has initiated several important initiatives to enhance collaboration between taxpayers and IRS personnel; to focus on important (as opposed to immaterial) issues; and, more generally, to empower its agents to resolve issues and settle cases more quickly and efficiently. Over the years, TEI is pleased to have cooperated in numerous efforts to bring greater efficiency to the examination process. One recent effort deserves mention — a project to develop a focused audit planning process, which was rolled out to taxpayers and LMSB personnel in October. The goals of the LMSB-TEI Joint Audit Planning Process are two-fold: (i) to establish accountability in executing a jointly developed audit plan, and (ii) to develop an issue-focused plan to, if you will, separate the wheat from the chaff and thereby increase audit efficiency. The resulting report emphasizes that the keys to a successful audit are communication, trust, and openness.

Joint Audit Planning — The Benefits of Collaboration

This project produced a planning and monitoring tool that lists the steps a taxpayer and audit team can take to enhance the quality and timeliness of tax examinations. A key to the initiative is the delineation of both the individual and the joint responsibilities of all participants — the taxpayer, team manager, audit team, specialists, and Counsel — thereby directing time and resources to the most important areas.

The Joint Audit Planning Process brings home the message that, even though taxpayers and the IRS sit on opposite sides of the table, they share an interest in ensuring that the resources expended in examining corporate tax returns are used efficiently and wisely. The initiative also underscores the continuing merit in collaborative efforts.

Several other innovative procedures — such as Limited Issue Focused Examination (LIFE), Pre-Filing Agreements, Fast Track Mediation and Settlement, Accelerated Issue Resolution, and Early Referral to Appeals — have also been introduced in the last few years to improve the examination process and promote currency. An informal survey of TEI members recently confirmed that LMSB's LIFE initiative — which focuses on materiality of issues and risk analysis of issues to be audited — is streamlining the examination process. We understand that LMSB's interim review of LIFE also validates this conclusion, and accordingly strongly recommend that future initiatives be designed to complement and supplement these programs, not replace or supplant them.

Advance Pricing Agreements

One initiative begun more than a decade ago that has worked exceedingly well is the advance pricing agreement (APA) program. This process permits taxpayers to work with the IRS to determine the appropriate price for transferring goods and services across international borders between related entities. A recent study found that 86 percent of companies identified transfer pricing as the most important international issue they face,[3] thereby confirming the need for innovative approaches to the area. Transfer pricing is not a tax shelter; it is the inevitable (and unavoidable) consequence of a global economy. And the APA program is designed not to "give away the store" — as some have intimated — but to reach a fair and equitable resolution of complex factual issues *before* the return is filed. Indeed, in TEI's view, the APA program is a model dispute avoidance and resolution program, and while it is appropriate to review and seek to improve the process, it would be a serious error to scale back or abandon the program.

Overriding Importance of Training

Training is an important aspect of these initiatives. Procedures such as these empower personnel to make decisions at the lowest level, to resolve disputes fairly and more quickly, and to husband and preserve resources. They also operate to enhance employee job satisfaction and encourage employees to pursue public service careers. Many agents are still receiving the training needed to implement the initiatives discussed in this testimony. In addition, it is our understanding that more significant changes are under consideration that will require even *more* training. While LMSB and the IRS generally should remain open to new ideas and programs, the costs and consequences of change cannot be ignored. Each new program creates new training needs, and a "flavor-of-the-month" approach to examination techniques has the potential for causing confusion

---

[3] *See* Tropin, *Concern Increasing Over Lack of Uniformity in Transfer Pricing Enforcement, E&Y Says*, BNA DAILY TAX REP., No. 218, p. G-4 (November 12, 2003).

and malaise in the field. Steps must be taken to ensure that agents receive consistent and timely training.

TEI recommends that LMSB revenue agents continue to be trained in alternative dispute resolution techniques. In addition, we believe that these audit techniques could be adapted for other divisions and may resolve some of the frustrations felt by personnel concerning their ability to make decisions.

Need for Simplification

Complexity in the tax system has important ramifications for tax administration and compliance. TEI also believes that complexity cannot help but contribute to employee job dissatisfaction. In his final report, former Commissioner Charles Rossotti observed that, during the five-year period ending in 2002, there were 19 enacted tax bills that changed 292 tax code sections and required 515 changes to forms and instructions. When the law is constantly changing and employees need more and more training just to keep up, morale is sure to suffer. The ongoing need for training also detracts from the IRS's goal of achieving currency on audits, affecting overall job performance and program results.

More than five years ago, TEI joined with the American Institute of Certified Public Accountants and the American Bar Association Section of Taxation to recommend changes to simplify the law not only for taxpayers — both large and small — but the government as well. We believe that even small changes — such as harmonizing the various definitions of "child" — can have a positive effect on job performance. Larger changes — such as the repeal of the alternative minimum tax — can have significant effect on taxpayers' ability to comply with the law and the IRS's ability to perform efficient and effective audits. Enactment of simplifying measures can ease pressures and make workers more productive. In this regard, we are pleased that the Treasury Department recently announced several simplification provisions in its 2005 budget request.

* * *

Tax Executives Institute commends the IRS Oversight Board for holding this public hearing. TEI looks forward to working with the Board and the IRS itself to improve tax administration.

TAX EXECUTIVES INSTITUTE, INC.

By:

Timothy J. McCormally
Executive Director